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October 20, 2008

AGENDA ITEM 5

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

- I. SUBJECT:** Policy Review and Consolidation Project – Revision to Real Estate Policies
- II. PROGRAM:** Real Estate
- III. RECOMMENDATION:** Recommend to the Investment Committee approval of the Statement of Investment Policy for Real Estate
- IV. ANALYSIS:**

Background

A comprehensive policy review was indicated as part of the Real Estate Strategic Plan recommended by the Board's real estate consultant, PCA Real Estate Advisors, Inc., and adopted by the Investment Committee in September 2007.

The Strategic Plan directed staff to review current assumptions concerning the portfolio in light of global investment conditions and determine where investment policies should be modified to reflect the new investment approach outlined in the Strategic Plan. Staff was also directed to bring revised policies to the Investment Committee, via the Policy Subcommittee, including establishing Value-Added and Opportunistic investment categories, as part of the Strategic Plan implementation timeline.

In addition to the Strategic Plan Implementation Item, existing Real Estate policies were previously scheduled for review as part of the overarching Investment Office Policy Review and Consolidation Project. This Project is a joint effort and includes input from the General Pension Consultant, the Board's Real Estate consultant, the CalPERS Legal Office, and the Office of Enterprise Compliance.

Proposed Framework

During late 2007 and early 2008 Staff completed a review of existing policies per the parameters of the Real Estate Strategic Plan and the Policy Review and Consolidation Project. At the June 2008 Policy Subcommittee meeting, Staff presented an information agenda item recommending development of a single overarching real estate policy. Attachment 1 illustrates the proposed Real Estate policy framework. Attachment 2 lists existing Real Estate policies and details where the content of existing policies will reside after the Policy Review and Consolidation Project is complete. Attachment 3 is the proposed policy. Also attached are review letters from PCA Real Estate Advisors, Inc. (Attachment 4), and Wilshire (Attachment 5).

Staff is recommending a single overarching real estate policy as it believes the approach will provide more effective policy directives and controls on investment activities. The following plan was submitted to the Policy Subcommittee in June:

1. Aim to consolidate existing twenty-five (25) policies (Attachment 2) developed over time into a new overarching Real Estate Equity Policy that maintains all of the Board's directives and intent while reducing the number of current policies. Proposed policy mirrors in form and structure, the policies of other private equity asset classes (i.e. AIM and ILAC).
2. Remove operational and procedural language from policies and place in Staff Internal Procedure Manual. Existing policies total 201 pages including extensive procedural language. Removal of procedural detail from policies is a normal part of the Policy Review and Consolidation Project but may be more extensive for Real Estate compared to other asset classes due to the size in number and breadth of existing Real Estate policies. By moving procedural detail to the Staff Internal Procedure Manual, the policy will be more streamlined and clear.
3. Incorporate policy changes necessary to reflect new Strategic Plan and current global investment conditions. See Key Changes section below for additional detail.
4. Maintain Responsible Contractor Program, Accounting, and Appraisal and Valuation policies as stand alone documents. Conduct further analysis and consultation with the Legal Office regarding the incorporation of the Hazardous Material policy into the parent policy document as an attachment or into the real estate guidelines.
5. The Fiscal Services Division and Investment Office Performance Monitoring Unit will propose and bring forward policy revision recommendations to the Subcommittee for the Accounting and Appraisal

& Valuation policies separate from the Real Estate Unit's portion of the review process. The Real Estate Unit will maintain ownership of the existing policies until the proposed policies are brought forward and adopted.

Staff emphasizes that the new policy document is comprehensive in scope and incorporates changes necessary to implement the Strategic Plan. Substantive changes from current policy are reported below. Given the extent of policy rewrite, the policy submission does not include black lined policies that have been part of the Investment Office Policy Review and Consolidation Project in the past.

PCA Real Estate Advisors, Inc. reviewed and concurred with the proposed framework.

Key Changes

At a strategic level, the following is a summary of key changes to existing policy:

1. **General Approach.** The proposed overarching policy covers strategic management and structure of the entire real estate portfolio in one document. This approach contrasts with existing real estate policies that are a set of twenty-five (25) stand alone documents addressing specific programs or structure types. Per the guidelines of the Investment Office Policy Review and Consolidation Project, procedural language has been excluded from the proposed policy. A Staff Internal Procedure Manual will be completed in 2009 that will detail procedures in the Real Estate Unit. Staff will continue to process transactions utilizing existing procedures until the new manual is completed. The Responsible Contractor Policy will remain separate. The Accounting, Appraisal and Valuation Policies will be brought to the Policy Subcommittee for review in February 2009 by the INVO Operations Unit. Attachments will be utilized for programs with specific policy requirements.
2. **Strategic Plan.** In September 2007, the Investment Committee adopted a Strategic Plan for the Real Estate program. The Strategic Plan was a comprehensive review of real estate strategy and recommended changes to real estate policies. Staff was directed to bring revised policies to the Investment Committee, via the Policy Subcommittee, as part of the Strategic Plan implementation timeline. This proposed policy incorporates the implementation items from the Strategic Plan including adding Value-Added and Opportunistic investment categories. In addition, the proposed policy reflects a global geographic approach recommended by the Strategic Plan.

3. **Programs with Specific Policy Requirements.** The draft policy includes attachments for For-Sale Residential and Land Development (Housing), California Urban Real Estate (CURE), and Public Real Estate Equity Securities. The attachments are recommended to be adopted as part of the Real Estate Policy; however, they are in different stages of development. As a result, Staff recommends the following measures for each attachment:
 - A. Housing Program (Attachment A) - Due to the ongoing strategic review of the housing program, Staff is proposing that a revised attachment be presented to the Policy Subcommittee in April 2009. In the interim period prior to submission of a new housing program attachment, any investment decision in the housing program will require approval from the Senior Investment Officer, a concurring recommendation from the Board's Real Estate Consultant, and a concurring recommendation from the applicable third party housing consultant. Also during this interim period, Staff will be required to obtain Investment Committee approval for any investment with a new housing partner.
 - B. CURE Program (Attachment B). Staff is proposing that a revised attachment that reflects results of the ongoing CURE program strategic review be presented to the Policy Subcommittee in June 2009. No interim measures for the CURE program are needed.
 - C. Public Real Estate Equity Securities (Attachment C). The Public Real Estate Equity Securities policy has been revised and is ready for adoption.
4. **Risk Classification.** Risk classifications are changed from Core and Non-Core, to Core, Value Add, and Opportunistic. The definition of Core has been revised to be more reflective of industry parlance. The public securities program was moved to Core. International assets may be included in Core, Value Add, and Opportunistic categories.
5. **Real Estate Delegation.** Adoption of the proposed policy will require changes to the Real Estate Delegations. Existing delegations are based on the current portfolio organization of Core and Non-Core risk classifications compared to Core, Value Add, and Opportunistic classifications in the proposed policy. A revised Real Estate Delegations document will be presented to the Investment Committee in February 2009.

6. **Diversification.** Diversification parameters include risk classification (core, value add, and opportunistic), geography, product type (office, retail, etc.), and structure (public versus private). Diversification requirements will apply to the entire portfolio as opposed to only the Core portfolio. Diversification calculations will be measured at the asset level, as opposed to the partnership level, for increased granularity.
7. **Hazardous Waste Risks.** Real Estate Staff and the Legal Office are currently analyzing the proper mitigations which should be incorporated either in this policy or the procedural manual. This analysis will be completed by December 2008.
8. **Leverage.** A new overall real estate portfolio limit is introduced with a 60% loan-to-value cap. The leverage limit for the Core portfolio was reduced from 50% to a 45% loan-to-value with Staff approvals for amounts over 40% removed. The Value Add and Opportunistic portfolios will have leverage limits of 65% and 75% respectively. This compares to an existing Non-Core limit of 75%.
9. **Loan Guarantees.** CalPERS' allowable loan guarantee amounts were reduced. The existing Leverage Policy allows for guarantees on loans up to 25% of the real estate portfolio target allocation. The new proposed policy allows for loan guarantees up to 10% of the Net Asset Value of the portfolio.
10. **Subscription Financing.** A 12 month limitation has been added for the utilization of subscription financing.
11. **Investment Structures.** Staff will be required to standardize investment structures and maintain a list of required provisions. Four structures will be allowed; Commingled Funds, Joint Ventures (Separate Accounts), Manager Contracts, and Real Estate Operating Companies.

Transitioning to New Policy

Upon adoption of this policy, staff will review the portfolio for compliance with this policy. In addition, existing operating agreements will need to be reviewed by Staff to ensure they comply with the new policy. Staff will complete this analysis and report our findings to the Investment Committee by June 30, 2009.

Implementation Timeline

The following timeline outlines the steps staff is proposing to complete the Policy Review and Consolidation Project:

Implementation Action	Expected Timing
Staff submits policy draft to PSC to begin Board review process.	October 2008 (1 st Reading)
Staff submits policy draft to PSC for additional review and comment.	December 2008 (2 nd Reading)
Real Estate Staff and LEGO complete analysis of Hazardous Waste risks and placement of mitigations in policy or procedures.	December 2008
Staff submits proposed policy to Investment Committee upon approval of PSC.	February 2009
Staff submits revised Real Estate Delegation to Investment Committee for review and approval.	February 2009
INVO Operations Staff submit proposed policies for Real Estate Accounting and Real Estate Appraisal and Valuation to the PSC for review and comment.	February 2009
INVO Operations Staff submit proposed policies for Real Estate Accounting and Real Estate Appraisal and Valuation to the Investment Committee upon approval of PSC.	March 2009
Staff submits updated Attachment A (For Sale Residential and Land Development) to PSC for review and comment.	April 2009
Staff submits updated Attachment B (CURE) to PSC for review and comment.	June 2009
Staff completes review of existing operating agreements for compliance with new policy and submits findings to the IC.	June 2009
Staff completes Staff Internal Procedure Manual.	September 2009

V. STRATEGIC PLAN:

The Real Estate Policy Review and Consolidation Project will further the following CalPERS Strategic Plan goals:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

V. RESULTS/COSTS:

There are no material costs associated with this agenda item.

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